(1) 931993 JUN - 6 1994

No. ——— OFFICE OF THE CLERK

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1993

IN RE WELLS FARGO SECURITIES LITIGATION

WELLS FARGO & CO., *et al.*,
Petitioners,

v.

HOWARD GREENWALD, *et al.*,
Respondents.

Petition For Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

PETITION FOR WRIT OF CERTIORARI

MELVIN R. GOLDMAN*
JACK W. LONDEN
PAUL FLUM
CAROLYN A. JOHNSTON
MORRISON & FOERSTER
345 California Street
San Francisco, CA 94104
(415) 677-7000

Attorneys for Petitioners

**Counsel of Record*

27 pp

QUESTIONS PRESENTED

1. Did the Ninth Circuit err in concluding, contrary to well-reasoned decisions from other circuits, that a complaint:

a. satisfies the misrepresentation element of a Rule 10b-5 claim by alleging that a bank's extraordinary increase in its loan loss reserve for one period implied that the reserve for a previous period was fraudulently understated?

b. satisfies the scienter element of a Rule 10b-5 claim by alleging that corporate defendants were motivated to perpetrate a fraud solely to maximize their compensation and job security?

2. Does this Court's decision in *Virginia Bankshares, Inc. v. Sandberg* establish a more lenient pleading standard for alleging fraud based on statements of opinion as opposed to fact?

PARTIES TO THE PROCEEDINGS

The parties to the proceedings below were defendants/petitioners: Wells Fargo & Co., Carl E. Reichardt, Paul Hazen, Robert L. Joss, Clyde W. Ostler, David M. Petrone, William F. Zuendt, Stephen A. Enna, Rodney L. Jacobs, Patrick W. Leahy, and Guy Rounsaville, Jr.; and plaintiffs/respondents: Howard Greenwald, Milton Friedman, Sheldon Shore, John Paul Decker, Fairmount Financial Corporation, Arthur-Magna, Inc., Harold Bloch, and Robert C. Schilling. Although the complaint alleges that this case has been brought as a class action, no certification of a class has yet been made.

Pursuant to Supreme Court Rule 29.1, Wells Fargo & Co. states that it has no parent companies. Wells Fargo & Co.'s non-wholly owned subsidiaries or affiliates are Wells Fargo Nikko Investment Advisors International, Wells Fargo Nikko Investment Advisors, Wells Fargo Foreign Funds Advisors, Wells Fargo Foreign Funds Management, S.A., and Mortgage Capital Partners. Petitioners are not aware of any parent companies or subsidiaries of respondents Fairmount Financial Corporation and Arthur-Magna, Inc.

TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES iv

OPINIONS BELOW 1

JURISDICTION 1

STATUTES AT ISSUE 1

STATEMENT OF THE CASE 1

REASONS FOR GRANTING THE PETITION 5

I. THE NINTH CIRCUIT'S OPINION CONFLICTS WITH THE STANDARD ADOPTED BY OTHER CIRCUITS IN CASES ALLEGING FRAUD BY HINDSIGHT 5

II. THE NINTH CIRCUIT'S OPINION CONFLICTS WITH THE STANDARD ADOPTED BY OTHER CIRCUITS FOR PLEADING SCIENTER IN SECURITIES FRAUD CASES 9

III. THE NINTH CIRCUIT'S OPINION REPRESENTS A MISAPPLICATION OF THIS COURT'S HOLDING IN *VIRGINIA BANKSHARES* 12

IV. THIS COURT'S GUIDANCE REGARDING THRESHOLD PLEADING STANDARDS IN SECURITIES CLASS ACTIONS IS OF VITAL SIGNIFICANCE TO LITIGANTS AND THE LOWER COURTS 14

CONCLUSION 17

TABLE OF AUTHORITIES

Page(s)

Cases

Anderson v. Liberty Lobby, Inc.,
477 U.S. 242 (1986) 17

Blue Chip Stamps v. Manor Drug Stores,
421 U.S. 723 (1975) 14-15, 16, 17

Celotex Corp. v. Catrett,
477 U.S. 317 (1986) 17

Central Bank, N.A. v. First Interstate Bank, N.A.,
114 S. Ct. 1439 (1994) 15, 17

Christidis v. First Pennsylvania Mortgage Trust,
717 F.2d 96 (3d Cir. 1983) 3, 8

Connecticut Nat'l Bank v. Fluor Corp.,
808 F.2d 957 (2d Cir. 1987) 10 n.9

Denny v. Barber,
576 F.2d 465 (2d Cir. 1987) 3, 8

DiLeo v. Ernst & Young,
901 F.2d 624 (7th Cir.),
cert. denied, 498 U.S. 941 (1990) ..... *passim*

Ernst & Ernst v. Hochfelder,
425 U.S. 185 (1976) 9, 12

Greenstone v. Cambex Corp.,
975 F.2d 22 (1st Cir. 1992) ..... 10 & n.9, 12 n.10

Hanna v. Plumer,
380 U.S. 460 (1965) 17

In re GlenFed, Inc. Sec. Litig.,
12 F.3d 893 (9th Cir. 1993),
reh'g en banc granted, No. 92-55419,
1994 U.S. App. LEXIS 3331
(9th Cir. Feb. 25, 1994) 8 n.7

In re Time Warner, Inc. Sec. Litig.,
9 F.3d 259 (2d Cir. 1993) 13, 14

In re VeriFone Sec. Litig.,
11 F.3d 865 (9th Cir. 1993) 6

Kowal v. MCI Communications Corp.,
16 F.3d 1271 (D.C. Cir. 1994) 6, 13, 14

Larson v. Domestic & Foreign Corp.,
337 U.S. 682 (1949)..... 14

Matsushita Elec. Indus. Co. v. Zenith Radio Corp.,
475 U.S. 574 (1986) 17

Mayer v. Myloa,
988 F.2d 635 (6th Cir. 1993) 12 n.11

O'Brien v. National Property Analysts Partners,
936 F.2d 674 (2d Cir. 1991) 12 n.10

Raab v. General Physics Corp.,
4 F.3d 286 (4th Cir. 1993) 13

Robin v. Arthur Young & Co.,
915 F.2d 1120 (7th Cir. 1990) 10 n.9, 12 n.10

Romani v. Shearson Lehman Hutton,
929 F.2d 875 (1st Cir. 1991) 6

Roots Partnership v. Lands' End, Inc.,
965 F.2d 1411 (7th Cir. 1992) 6

Shapiro v. UJB Fin. Corp.,
964 F.2d 272 (3d Cir.),
cert. denied, 113 S. Ct. 365 (1992) 12 n.11

Sinay v. Lamson & Sessions Co.,
948 F.2d 1037 (6th Cir. 1991) 6

Tuchman v. DSC Communications Corp.,
14 F.3d 1061 (5th Cir. 1994) 10-11, 12 n.10

Virginia Bankshares, Inc. v. Sandberg,
111 S. Ct. 2749 (1991) ..... 4, 12 & n.11, 13, 14

Wexner v. First Manhattan Co.,
902 F.2d 169 (2d Cir. 1990) 10

Wilkes v. Heritage Bancorp, Inc.,
767 F. Supp. 1166 (D. Mass. 1991) 9

Statutes and Rules

Securities Exchange Act of 1934,
section 10(b), 15 U.S.C. § 78j(b) 9
section 27, 15 U.S.C. § 78aa 2 n.2

28 U.S.C.
§ 1254.1 1
§ 1367 ..... 2 n.2

Fed. R. Civ. P.
Rule 9(b) ..... *passim*
Rule 12(b) 1
Rule 12(b)(6) ..... *passim*

Securities and Exchange Commission Rule 10b-5,
17 C.F.R. § 240.10b-5 ..... 12, 15

Other Authorities

Janet C. Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions,* 435 Stan. L. Rev. 497 (1991) 14 n.12

1992 Annual Report of the Director of the Administrative Office of the United States Courts, Table C-2 .... 16 n.14

Bank Credit (H.V. Prochnow ed. 1981) 7

10 Banking Policy Report, No. 23 (Dec. 2, 1991) 15 n.13

Brent Bowers and Udayan Gupta, *Shareholder Suits Beset More Small Companies,* Wall St. J., Mar. 9, 1994 16

Class Action Reports, Vol. 15, No. 4, Table 4 (1992) 16 n.14

Francis X. Conway and William A. Siegenhaler, *Loan Loss Reserves: Tax, Regulatory and Adequacy Issues,* 70 J. Comm. Bank Lending, No. 1 (1987) 7

N.Y. Times, Oct. 18, 1993, Sec. D, col. 6 ..... 9 n.8

Note, Using Rule 9(b) to Reduce Nuisance Securities Litigation, 99 Yale L.J. 1591 (1990) 16

Office of the Comptroller of the Currency,
Comptroller's Handbook for National Bank Examiners § 217.1 (1984) 7

Office of the Comptroller of the Currency,
Banking Circular 201 (Rev.),
5 Fed. Banking L. Rep. (CCH)
¶ 51,132 (Feb. 20, 1992) 7, 13

SEC Financial Reporting Release No. 28,
6 Fed. Sec. L. Rep. (CCH) ¶ 73,126
(Dec. 1, 1986) 7

Wall St. J., Nov. 17, 1993, Sec. C, col. 3 ..... 9 n.8

OPINIONS BELOW

This petition seeks review of the opinion of the Ninth Circuit Court of Appeals reversing dismissal of this shareholder class action and reinstating plaintiffs' Amended Complaint (the "complaint"). The opinion of the Court of Appeals is reported at 12 F.3d 922 (9th Cir. 1993). The opinion of the District Court for the Northern District of California is not published. The full text of the opinions appears in the Appendix beginning at pages a-1 and a-19, respectively.[1]

JURISDICTION

The judgment of the Court of Appeals was entered on December 29, 1993. A timely petition for rehearing and suggestion for rehearing *en banc* was denied on March 8, 1994. (a-24.) The judgment may be reviewed by this Court by writ of certiorari granted under 28 U.S.C. § 1254.1.

STATUTES AT ISSUE

This petition raises issues involving the proper construction of Rule 9(b) and Rule 12(b)(6) of the Federal Rules of Civil Procedure as applied to a motion to dismiss a shareholder class action complaint. The full text of Rule 9(b) and Rule 12(b) appears in the Appendix. (a-77.)

STATEMENT OF THE CASE

This case arises out of a fall in the price of Wells Fargo & Co. common stock following a June 25, 1991 announcement that Wells Fargo Bank would be adding $350 million to its loan loss reserve for the quarter ended June 30, 1991. (a-30.) The bank also announced that it would recognize $180 million in actual loan losses for that quarter, which was far below the existing $885 million loan loss reserve. (a-54; a-56.) Wells Fargo stock, which had been trading at a previous high of $97.00 per share, dropped from $81.50 to $74.00 per share on the news. (a-56.) The first of five class actions against

---

1. All citations with the "a-" prefix refer to petitioners' Appendix, filed herewith.

Wells Fargo and its officers and directors was filed in the United States District Court for the Northern District of California the day the reserve increase was announced.[2]

That complaint, as subsequently amended, claims that the defendants, who are officers or directors of Wells Fargo, knew or should have known that the loan loss reserve had been materially understated in Wells Fargo's 1990 Annual Report, filed March 5, 1991, and its first quarter 1991 Form 10-Q. The claimed fraud allegedly led to overstated profits and inflated stock prices for the sixteen-week period between March 5, 1991 and the June 25 announcement.[3]

The complaint does not contend that Wells Fargo's Annual Report or Form 10-Q inaccurately stated the loan loss reserve established by the bank. Rather, the complaint contends that the Annual Report falsely stated that the reserve was "adequate," and failed to disclose the status of loans that defendants knew were "in jeopardy." (a-47; a-54.) Other than naming nine representative borrowers, the complaint contains no allegations of how the reserve failed properly to reflect the loans, or in what respect loans were "in jeopardy." (a-47.)

The complaint alleges that defendant officers and directors knew or should have known of unspecified problems, and were motivated to conceal those problems — through delaying an increase in the loan loss reserve — by their desire to maximize earnings, job security, and the value of their Wells Fargo stockholdings. (a-38; a-69.) The complaint does not allege how defendants became aware of these problems, or even identify, except in conclusory fashion, what the

---

2. The District Court's jurisdiction was based on section 27 of the Securities Exchange Act of 1934 (15 U.S.C. § 78aa) and principles of supplemental jurisdiction (28 U.S.C. § 1367).

3. The complaint alleges that the bank, like all other banks, is required to maintain a loan loss reserve, which the bank adjusts each quarter to maintain the reserve "at an appropriate level consistent with the risk of loss actually faced." (a-45.) Because each quarter's loan loss provision is charged against current income, an alleged understatement of the provision, and hence the reserve, results in an alleged overstatement in earnings.

problems allegedly were. Nor does the complaint allege that defendants sold Wells Fargo stock in anticipation of the reserve increase or earned some other benefit solely by delaying recognition of the alleged problems.

Defendants moved to dismiss the complaint under Rules 9(b) and 12(b)(6) of the Federal Rules of Civil Procedure. (a-25 to a-26.) The District Court granted the motion with prejudice, stating that "[n]othing in plaintiffs' voluminous complaint states facts which support a coherent theory of securities fraud." (a-20.)

A three-judge panel of the Ninth Circuit reversed in a split decision, with Judge Trott dissenting. The majority held that the disclosure of a loan loss reserve, while literally accurate, could be actionable if, as the complaint alleged, "Wells Fargo's statement of its loan loss reserves failed to disclose — *i.e.*, failed to reflect — certain loans that Wells Fargo knew were 'in jeopardy.'" (a-5.) The majority, noting that the District Court had not based dismissal on Rule 9(b) (a-2 n.1), ignored the requirements of that rule in assessing the sufficiency of the complaint's allegations, and concluded that the complaint contained sufficient facts to support an inference that the loan loss reserve had been fraudulently understated.

The majority acknowledged that other courts of appeals hold that a plaintiff must allege "something more" than an increase in a bank's loan loss reserve to state a claim for securities fraud. (a-6.) *See, e.g., Denny v. Barber*, 576 F.2d 465 (2d Cir. 1978); *Christidis v. First Pennsylvania Mortgage Trust*, 717 F.2d 96 (3d Cir. 1983); *DiLeo v. Ernst & Young*, 901 F.2d 624 (7th Cir.), *cert. denied*, 498 U.S. 941 (1990). According to the majority, plaintiffs met that standard by listing in a conclusory fashion nine HLT loans "which, in their view,

Wells Fargo should have recognized by adjusting its reserves accordingly." (a-5; a-6.) [4]

The majority found further support for plaintiffs' claims in the allegation that Wells Fargo's Annual Report set forth management's *belief* that the loan loss reserve was "adequate," and that some of the loans were "substantially secured." (a-12.) Relying on this Court's decision in *Virginia Bankshares, Inc. v. Sandberg*, 111 S. Ct. 2749 (1991), the majority ruled that these statements were potentially actionable statements of belief, and that plaintiffs could proceed on the theory that management had no basis for believing the statements to be true when they were made. (a-12.)

Finally, the majority held that the conclusory allegation that officers and directors "became aware" of foreseeable problems in the loan portfolios, and were motivated to delay an increase in the reserve to "maximize" their compensation and job security, was a sufficient averment of scienter. (a-3; a-14.)

Judge Trott dissented, noting that on the date of oral argument in the Ninth Circuit, Wells Fargo stock was trading at $104.75 per

---

4. The allegations about the nine borrowers are remarkable for their generality. The complaint states in pertinent part:

> When the promoters of HLTs [highly leveraged transactions] and real estate developers began to experience financial difficulties and/or problems in repaying the loans prior to and at the beginning of the Class Period, Defendants were on notice that a substantial portion of Wells Fargo's outstanding HLT Loans and real estate loans were in jeopardy, particularly in light of the information that was available to the Individual Defendants as sophisticated officers and directors of this major bank holding company.
>
> []. Defendants, however, did not disclose these facts nor did they establish adequate provisions for loan losses on these loans. *Among the high-risk HLT Loans for which Defendants were on notice of these problems were, inter alia, Revco D.S., Insilco Corp., Charter Medical Group, R.H. Macy & Co., Campeau Corp., Jim Walters Corp., Gaylord Container Corp., West Point Pepperell, Inc., and NWA, Inc.*

(a-47; emphasis added.)

share, higher than the pre-announcement high.[5] Judge Trott observed, "This is an interesting kind of fraud where the value of the disputed stock before the case goes to trial exceeds its value before the alleged wrongdoing that caused it to 'collapse.'" (a-17.) Judge Trott agreed with the District Court that "'[t]he fact that defendants increased loan loss reserves in the second quarter, and at all times relevant accurately reported the amount of actual reserves set aside by the bank, does not by itself allege securities fraud, notwithstanding conclusory statements of fraud in the complaint.'" (a-16.) Judge Trott further agreed that the fact that plaintiffs were able to "'list customers of the Bank who are known today to be burdened with debt'" adds nothing to a complaint which alleges no more than "'fraud by hindsight.'" (a-16 to a-17.)

The Ninth Circuit denied defendants' petition for rehearing and suggestion for rehearing *en banc* on March 8, 1994. (a-24.)

REASONS FOR GRANTING THE PETITION

I. THE NINTH CIRCUIT'S OPINION CONFLICTS WITH THE STANDARD ADOPTED BY OTHER CIRCUITS IN CASES ALLEGING FRAUD BY HINDSIGHT

The Ninth Circuit found that the crux of plaintiffs' complaint was their claim that the extraordinary increase in Wells Fargo's loan loss reserve on June 25, 1991 should have been made three months earlier. (a-3.) The Ninth Circuit's holding that these conclusory allegations were sufficient to state a claim for securities fraud is contrary to holdings in other similar loan loss reserve cases, and to a far broader category of cases involving forward-looking statements in general.[6]

---

5. On June 2, 1994, Wells Fargo's closing stock price was $156.50 per share.

6. As used herein, the term "forward-looking statement" refers to any statement used by a corporation or its management regarding future developments. For example, disclosures of financial forecasts, predictions of economic trends, and management's plans for future operations are types of forward-looking statements.

Decisions from other circuits reject claims of fraud by hindsight based on forward-looking statements. These courts hold that to state a cause of action based on a forward-looking statement, securities fraud plaintiffs must plead *facts* which, if true, would establish that the forward-looking statement lacked a reasonable basis. *See, e.g., Romani v. Shearson Lehman Hutton*, 929 F.2d 875, 878 (1st Cir. 1991); *Sinay v. Lamson & Sessions Co.*, 948 F.2d 1037, 1042 (6th Cir. 1991). *See also In re VeriFone Sec. Litig.*, 11 F.3d 865, 871 (9th Cir. 1993).

For example, in *Kowal v. MCI Communications Corp.*, 16 F.3d 1271, 1278 (D.C. Cir. 1994), the Court of Appeals for the District of Columbia affirmed dismissal of a complaint alleging that a forward-looking statement was fraudulent. As in this case, the complaint "point[ed] to the 'gross deviation' between the results actually achieved by MCI and the results that MCI predicted would be achieved." The court emphatically rejected this "theory" of fraud:

> The fact that the Company's performance did not conform to that predicted supports no inference that MCI's statements lacked a reasonable basis when made . . . . A failure to meet projected earnings or revenues "does not in itself suggest the goal fell outside the realm of reasonable probability and therefore lacked a reasonable basis."

Id. (citations omitted).

The court further held that conclusory allegations of undisclosed facts, which purportedly undermine the basis for the forward-looking statement, are insufficient to state a claim for securities fraud. *Id.* at 1279; *see also Roots Partnership v. Lands' End, Inc.*, 965 F.2d 1411, 1418 (7th Cir. 1992).

Similarly, courts of appeals outside the Ninth Circuit hold that a complaint basing a securities fraud claim on the increase in a bank's loan loss reserve does not support an inference of fraud. As these courts recognize, the vice of permitting plaintiffs to proceed on a theory of fraud by hindsight is exacerbated in a case challenging an extraordinary increase in a bank's loan loss reserve. A reserve for loan losses appears on every bank's financial statement as a deduction from the value of the loan portfolio. Every bank is required to evaluate the collectibility of loans in its portfolio at a given time, and reserve an

amount adequate to absorb anticipated losses. Office of the Comptroller of the Currency, Banking Circular 201 (Rev.), 5 Fed. Banking L. Rep. (CCH) ¶ 51,132, at 30,133-4 (Feb. 20, 1992). According to the regulators, the reserve should include only losses "that probably exist[] based on information that is available as of the evaluation date." The amount of the loss "must be subject to reasonable estimation," and should not include "losses that may occur as a result of possible future events." *Id.* at n.1.

The Office of the Comptroller of the Currency, the Securities and Exchange Commission, and commentators all recognize that, unlike objective entries on a financial statement such as inventory and sales, the calculation of the loan loss reserve is inherently subjective. It has been described as "an art and not a science," which "necessarily involves a high degree of management judgment." SEC Financial Reporting Release No. 28, 6 Fed. Sec. L. Rep. (CCH) ¶ 73,126, at 62,760 (Dec. 1, 1986); Francis X. Conway and William A. Siegenhaler, *Loan Loss Reserves: Tax, Regulatory and Adequacy Issues*, 70 J. Comm. Bank Lending, No. 1, at 15 (1987). There is "no way to assure complete accuracy" in setting a loan loss reserve. 70 J. Comm. Bank Lending, No. 1, at 10. *See also* Office of the Comptroller of the Currency, *Comptroller's Handbook for National Bank Examiners* § 217.1, at 2 (1984).

In addition, each statement of the loan loss reserve relates to a new period. Because the loan loss reserve "is only understood in a dynamic sense," *Bank Credit* 356 (H.V. Prochnow ed. 1981), a change in the loan loss reserve from period to period is the rule, not the exception, and says nothing about the adequacy of the reserve during an earlier period.

Thus, courts of appeals outside the Ninth Circuit reject hindsight claims that loan losses had been "fraudulently understated," based on subsequent reserve increases. For example, in *DiLeo v. Ernst & Young*, 901 F.2d 624, 626 (7th Cir.), *cert. denied*, 498 U.S. 941 (1990), the complaint alleged that before the understated loan loss reserve was disclosed to prospective shareholders, defendants "'became aware that a substantial amount of the receivables reported in Continental's financial statements were likely to be uncollectible.'" *Id.* The court

observed, "If all that is involved is a dispute about the timing of the write-off, based on estimates of the probability that a particular debtor will pay, we do not have fraud; we may not even have negligence." *Id.* at 627. The court concluded that the plaintiffs had failed to allege facts which, if true, would show "that the problems were so apparent that reserves should have been jacked up before the end of 1983 — why failure to increase the reserves amounted to 'fraud.'" *Id.*

The Second and Third Circuits have rejected similar claims of "fraud by hindsight," holding that an extraordinary increase in a bank's loan loss reserve does not, standing alone, state a claim for securities fraud. *See, e.g., Denny v. Barber*, 576 F.2d 465 (2d Cir. 1978); *Christidis v. First Pennsylvania Mortgage Trust*, 717 F.2d 96 (3d Cir. 1983).[7]

While the Ninth Circuit paid lip service to these decisions, its holding cannot be reconciled with them. The Ninth Circuit, acknowledging that "something more" was required than just an extraordinary increase in the reserve, found "something more" in plaintiffs' conclusory allegation that loans to nine named borrowers were "in jeopardy." (a-5; a-6.) Conclusory, vague allegations about nine loans do not explain or support plaintiffs' theory of fraud any more than do conclusory, vague allegations about the bank's loan portfolio as a whole. The complaint contains no facts supporting the assertion that the nine loans were "in jeopardy," much less that there were any losses of principal or interest, or contractual defaults. Moreover, even if the nine loans named by plaintiffs were "in jeopardy" in March of 1991, that would not prove that the reserve was fraudulently understated, since there is no allegation either that defendants failed to consider the nine loans in establishing the loan loss reserve

---

7. The opinion in this case also conflicts with the decision by another Ninth Circuit panel in *In re GlenFed, Inc. Sec. Litig.*, 11 F.3d 843 (9th Cir. 1993). In that case, the Ninth Circuit held that similar allegations that a bank had knowingly understated its loan loss reserve did not raise an inference of fraud. That decision is currently being reviewed by the Ninth Circuit *en banc*. 1994 U.S. App. LEXIS 3331 (9th Cir. 1994) (No. 92-55419).

in the first quarter of 1991, or that those nine loans accounted for the second quarter reserve increase.

Indeed, in this case, even hindsight does not work in plaintiffs' favor. While it may have appeared during the 1991 recession that Wells Fargo and other banks had under-reserved in 1990 and early 1991, and bank stock prices fell as a result, stock prices have recovered beyond pre-recession highs. Analysts now believe that Wells Fargo and other banks *over-reserved* in 1990 and 1991.[8]

Finally, the Ninth Circuit improperly ignored the requirements of Rule 9(b) in ruling on the adequacy of the complaint in this case. The Ninth Circuit opinion does not mention Rule 9(b), except to point out that the District Court's dismissal was based on Rule 12(b)(6). (a-2 & n.1.) Although defendants moved under both Rules (a-26), the District Court did not reach the additional requirements of Rule 9(b), given its conclusion that the complaint did not pass muster under Rule 12(b)(6). (a-20 to a-21.) The Ninth Circuit should not have ended its inquiry after it reached the opposite conclusion regarding Rule 12(b)(6); it was required to consider Rule 9(b), since the motion to dismiss was based on both Rules, and since a plaintiff must comply with both Rules to state a claim for securities fraud. *See, e.g., Wilkes v. Heritage Bancorp, Inc.*, 767 F. Supp. 1166, 1169 (D. Mass. 1991).

II. THE NINTH CIRCUIT'S OPINION CONFLICTS WITH THE STANDARD ADOPTED BY OTHER CIRCUITS FOR PLEADING SCIENTER IN SECURITIES FRAUD CASES

This Court held in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976), that to plead a violation of section 10(b), a plaintiff must allege facts raising an inference of scienter — an "intent to deceive, ma-

---

8. *See, e.g.*, Wall St. J., Nov. 17, 1993, Sec. C at 2, col. 3 ("many believe that Wells Fargo is now enormously over-reserved — to the tune of $1 billion, by some estimates"); N.Y. Times, Oct. 18, 1993, Sec. D at 1, col. 6 ("bad loans in 1990 and 1991 were overstated to such a degree that [banks] can now recoup some of the charges that caused big losses in earlier years").

nipulate, or defraud." The only "facts" cited by the Ninth Circuit regarding scienter are plaintiffs' conclusory allegations that defendants "became aware" that problems in Wells Fargo's loan portfolio were foreseeable, and were motivated to delay disclosure

> by the desire to "continue and prolong the image of Wells Fargo as a well-managed enterprise with sound lending procedures" and thus, maximize their individual compensation, the value of their personal Wells Fargo & Co. stock holdings, and their job security.

(a-3.) The Ninth Circuit held that these conclusory allegations were sufficient to satisfy the scienter element of plaintiffs' claim. (a-14.)

Once again, that holding directly conflicts with recent decisions from other circuits. *See, e.g., Tuchman v. DSC Communications Corp.*, 14 F.3d 1061, 1067-69 (5th Cir. 1994); *Wexner v. First Manhattan Co.*, 902 F.2d 169, 172 (2d Cir. 1990); *Greenstone v. Cambex Corp.*, 975 F.2d 22, 25 (1st Cir. 1992); *DiLeo v. Ernst & Young*, 901 F.2d at 627.[9]

For example, in *Tuchman v. DSC Communications Corp.*, 14 F.3d 1061 (5th Cir. 1994), the complaint alleged that defendants were motivated by their desire to keep their jobs, increase their compensation, and inflate the value of their shares in the company. The Fifth

---

9. Rule 9(b) provides that while a person's state of mind may be alleged generally, "the circumstances constituting fraud or mistake shall be stated with particularity." In *Connecticut Nat'l Bank v. Fluor Corp.*, 808 F.2d 957 (2d Cir. 1987), the Second Circuit explained how the two clauses are reconciled:

> The absence of a requirement that scienter be alleged with "great specificity" is based on the premise that a plaintiff realistically cannot be expected to plead a defendant's actual state of mind. This does not mean, however, that plaintiffs are relieved of their burden of pleading circumstances that provide at least a minimal factual basis for their conclusory allegations of scienter. "It is reasonable to require that the plaintiffs specifically plead those events" which "give rise to a strong inference" that the defendants had an intent to defraud, knowledge of the falsity, or a reckless disregard for the truth.

Id. at 962 (citations omitted). *See also Robin v. Arthur Young & Co.*, 915 F.2d 1120, 1127 (7th Cir. 1990); *Greenstone*, 975 F.2d at 25.

Circuit held that those allegations did not "set out facts sufficient to lead to a proper inference of scienter." *Id.* at 1068. The Fifth Circuit observed that "'were the opposite true, the executives of virtually every corporation in the United States would be subject to fraud allegations'." *Id.* Similarly, in *DiLeo*, the Seventh Circuit concluded that it made no sense to infer that the accountants who audited financial statements of a client had engaged in a fraud:

> An accountant's greatest asset is its reputation for honesty, followed closely by its reputation for careful work. Fees for two years' audits could not approach the loss E & W would suffer from a perception that it would muffle a client's fraud.

901 F.2d at 629.

The decision by the Ninth Circuit that the complaint adequately pleads scienter is a radical and unwise departure from these well-reasoned decisions. Under the rule expressed in this case, an inference of fraudulent intent can be drawn from facts that are entirely consistent with innocent conduct. The complaint does not allege that the content or timing of Wells Fargo's disappointing financial disclosures made any difference in the individual defendants' job security or compensation. Nor does the complaint allege that Wells Fargo insiders sold stock in anticipation of the reserve increase. Absent such allegations, it does not logically follow that a temporary delay of an increase in Wells Fargo's loan loss reserve would benefit any of the officer and director defendants. If anything, logic supports the opposite inference — it would be irrational for bank executives knowingly and

intentionally to understate the bank's loan loss reserve. *See DiLeo*, 901 F.2d at 629.[10]

If, as the Ninth Circuit held, plaintiffs can base a charge of securities fraud on scienter allegations no more consistent with dishonest than with innocent conduct, they can impose the tremendous cost of discovery and motion practice — not to mention grievous injury to reputation — on individuals of whom there is *no reason to suspect fraud*. That disserves the investing community generally, and is contrary to Rule 9(b) and to this Court's directive that a defendant may not be found liable under Rule 10b-5 "unless he acted other than in good faith." *Hochfelder*, 425 U.S. at 206.

III. THE NINTH CIRCUIT'S OPINION REPRESENTS A MISAPPLICATION OF THIS COURT'S HOLDING IN *VIRGINIA BANKSHARES*

The Ninth Circuit concluded that this case was governed by *Virginia Bankshares, Inc. v. Sandberg*, 111 S. Ct. 2749, 2758 n.6 (1991), because the complaint alleges that Wells Fargo's Annual Report stated management's *belief* that the loan loss reserve was "adequate" and that HLT loans were "substantially secured." (a-12 to a-13.)[11] Even if *Virginia Bankshares* could apply to such a statement of management belief, the Ninth Circuit erred in concluding that the complaint adequately pleaded that these statements were fraudulent.

---

10. Absent sufficient allegations of motive, scienter can be pleaded by alleging particularized facts supporting an inference that defendants knew or should have known of the fraud. No such particularized facts can be found in the complaint. To the extent the Ninth Circuit held that plaintiffs satisfied the scienter requirement with conclusory allegations that defendants "became aware" of problems with the bank's loan portfolio, its holding likewise conflicts with the other circuits' views of minimum requirements for pleading scienter. *See, e.g., Greenstone*, 975 F.2d at 25; *O'Brien v. National Property Analysts Partners*, 936 F.2d 674, 676 (2d Cir. 1991); *Tuchman*, 14 F.3d at 1068; *Robin*, 915 F.2d at 1127.

11. While the opinion does not cite *Virginia Bankshares* for this proposition, it does cite decisions that relied on *Virginia Bankshares* to find statements of opinion actionable. *Shapiro v. UJB Fin. Corp.*, 964 F.2d 272, 282 (3d Cir.), *cert. denied*, 113 S. Ct. 365 (1992); *Mayer v. Mylod*, 988 F.2d 635, 639 (6th Cir. 1993).

While *some* statements of management's belief *can* be actionable under *Virginia Bankshares*, that holding does not immunize claims based on allegedly fraudulent statements of management's belief from compliance with minimum pleading requirements under Rules 9(b) and 12(b)(6). To the contrary, *Virginia Bankshares* did not change or even address threshold pleading requirements in securities fraud cases. *Virginia Bankshares* certainly did not change the rule that *conclusory* attacks on statements of belief or opinion fail as a matter of law. *See, e.g., Kowal v. MCI Communications Corp.*, 16 F.3d 1271, 1277-79 (D.C. Cir. 1994); *In re Time Warner, Inc. Sec. Litig.*, 9 F.3d 259, 266 (2d Cir. 1993).

Plaintiffs' allegation that management falsely stated its *belief* that the loan loss reserve was adequate is no more particularized than an allegation that the reserve itself was fraudulently understated. Certainly such an allegation raises no inferences in addition to or different from those arising from reporting the loan loss reserve as a line item in the bank's financial statement without editorial comment. Either way, the alleged misrepresentation rests on the same unwarranted inference — that the increase in the reserve *must be* due to fraud. As discussed in Section I, above, the mere fact that the loan loss reserve increased says nothing about whether the previous reserve was adequate. If the rule were otherwise, every increase in the loan loss reserve would be grounds for a shareholder lawsuit, since every statement of the reserve contains an implied representation that management believes the reserve to be adequate. *See* OCC Banking Circular 201 (Rev.), 5 Fed. Banking L. Rep. (CCH) ¶ 51,132, at 30,133-4 (Feb. 20, 1992). *See also Raab v. Gerard*, 4 F. 3d 286, 290 (4th Cir. 1993).

Nor does an allegation that management stated its *belief* that loans to HLT borrowers were substantially secured add anything to plaintiffs' allegations. Once again, whether the statement is viewed as one of fact or of opinion, plaintiffs' allegation is wholly conclusory. Plaintiffs allege no particularized facts showing that HLT loans were not substantially secured, much less that management knew or should have known those alleged facts. While the complaint does at one point identify nine well-known HLT borrowers (a-47), the complaint does not allege how significant those nine loans were in rela-

tion to the size of the reserve, to the size of the overall portfolio, or even to any narrower category of loans. Nor does the complaint allege that those nine loans were not substantially secured.

Whether the challenged statements are characterized as fact or opinion, the complaint was therefore subject to dismissal for failure to state a claim under both Rule 9(b) and Rule 12(b)(6). The Ninth Circuit's apparent conclusion that statements of opinion should be held to a lesser pleading standard than statements of fact is an unwarranted extension of *Virginia Bankshares*, which conflicts with decisions from other circuits such as *Kowal* and *In re Time Warner*.

IV. THIS COURT'S GUIDANCE REGARDING THRESHOLD PLEADING STANDARDS IN SECURITIES CLASS ACTIONS IS OF VITAL SIGNIFICANCE TO LITIGANTS AND THE LOWER COURTS

Respondents will no doubt argue that there will be time enough for this Court to review this case following entry of final judgment. That argument ignores the substantial burden imposed on the lower courts and on businesses in general by shareholder class action litigation. It also ignores the reality that the overwhelming majority of companies (and their officers and directors) named as defendants in these cases settle, rather than face the expense, disruption and uncertainty of vindicating their position on the merits.[12] In any event, this Court has held that it is appropriate to review a case in this posture, since the issues raised in this petition are "'fundamental to the further conduct of the case.'" *Larson v. Domestic & Foreign Commerce Corp.*, 337 U.S. 682, 685 n.3 (1949).

As this Court has recognized, the costs of allowing a securities fraud case to proceed beyond the pleadings stage are great. *Blue Chip*

---

12. *See* Janet C. Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 435 Stan. L. Rev. 497, 525-26 (1991) ("no more than two securities class actions involving public corporations went to trial in federal court in the United States during 1987. . . . [S]ecurities class actions are adjudicated considerably less often than other types of cases").

Stamps v. Manor Drug Stores, 421 U.S. 723, 739 (1975) ("litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general"). This Court has also recognized that the costs of defending these suits, and the disruption they can cause, impose a great financial burden on the very shareholders that Rule 10b-5 was intended to benefit. *See Central Bank, N.A. v. First Interstate Bank, N.A.*, 114 S. Ct. 1439, 1454 (1994).

That concern applies with special force to litigation over an alleged understatement of a bank's loan loss reserve, given the nature of the discovery that plaintiffs can be expected to pursue. In an action based on conclusory allegations of an increase in the loan loss reserve, plaintiffs' proposed discovery will likely seek production of every loan file maintained by the bank, in an effort to show that a particular credit should have been, but was not, reflected in the reserve. The time period covered by such discovery will likely be expansive under a theory that the bank's historical experience with particular borrowers or industries bears on the adequacy of current reserves. In addition, plaintiffs will likely seek to depose every witness associated with setting the reserve or generating or reviewing any problem loans. For any bank, responding to such discovery would be both burdensome and disruptive, leading many banks to settle groundless suits to avoid the costs of defense.[13]

This Court has voiced concern about the social cost of corporations paying large amounts to settle meritless suits, based on their nuisance value:

> To the extent that [the discovery process] permits a plaintiff with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value, rather than a reasonably founded hope that the pro-

---

13. Many banks are now faced with similar lawsuits arising out of increases to their loan loss reserves during the recent recession. More than one hundred lawsuits were filed from 1989 to 1991 challenging the timing of increases in loan loss reserves. *See* 10 Banking Policy Report, No. 23, at 1 (Dec. 2, 1991).

> cess will reveal relevant evidence, it is a social cost rather than a benefit.

Blue Chip Stamps, 421 U.S. at 741. Since *Blue Chip Stamps* was decided, the price attached to this "social cost" has risen at a staggering rate. The total amount paid to settle shareholder class actions in 1992 was $1.55 billion, more than five times the amount in 1988. The number of such settlements increased from 53 in 1988, to 144 in 1992, and the average cash settlement increased from $6.1 million to $10.8 million. Brent Bowers and Udayan Gupta, *Shareholder Suits Beset More Small Companies*, Wall St. J., Mar. 9, 1994, at B1.[14]

Another social cost imposed by the lower courts' inability to dismiss meritless securities fraud claims at the pleadings stage is erosion of public confidence in the courts:

> The securities nuisance litigation-settlement cycle constitutes abuse of process by the plaintiff's bar at the expense of target defendants' shareholders and customers. To fund the settlement of non-meritorious suits, defendants may need to reduce or eliminate dividends to their shareholders, take an earnings "hit," and/or raise product prices and pass the cost on to the consuming public. In addition, this misappropriation receives a legal imprimatur that ultimately undermines public confidence in the legal system.

Note, *Using Rule 9(b) to Reduce Nuisance Securities Litigation*, 99 Yale L.J. 1591, 1600 (1990) (footnote omitted).

Rules 9(b) and 12(b)(6) are the most effective procedural devices for reducing these social costs. The significance of these rules in the overall context of securities litigation cannot be overstated. Properly applied, Rules 9(b) and 12(b)(6) permit the district courts to sift through boilerplate allegations and eliminate those securities fraud complaints that lack a factual basis, before huge litigation costs are in-

---

14. The most recent figures show that 2,002 new securities cases were filed in the federal courts for the year ending September 30, 1992, 268 of which were class actions. 1992 Annual Report of the Director of the Administrative Office of the United States Courts, Table C-2, at 178-79; *Class Action Reports*, Vol. 15, No. 4, Table 4, at 389 (1992).

curred. Thus, district courts can dismiss groundless lawsuits and prevent "disruption of normal business activities" through "abuse of the liberal discovery provisions of the Federal Rules of Civil Procedure," which is of particular concern in this type of case. *Blue Chip Stamps*, 421 U.S. at 741, 742-43.

The circuit conflict over threshold pleading standards in securities class actions has created confusion in the lower courts regarding what test to apply in deciding when to dismiss such complaints. *Cf. Central Bank, N.A. v. First Interstate Bank, N.A.*, 114 S.Ct. 1439, 1454 (1994) (recognizing the importance of certainty and predictability in the rules for determining civil liability for securities fraud). Review to resolve this conflict is particularly appropriate because it involves interpretation of a provision of the Federal Rules of Civil Procedure that this Court has never addressed. *See, e.g., Hanna v. Plumer*, 380 U.S. 460, 463 (1965) (granting certiorari "[b]ecause of the threat to the goal of uniformity of federal procedure posed by the decision below"). This Court should issue the writ to clarify the authority of the district courts to terminate meritless lawsuits like this one at the pleading stage, and avoid the imposition of costly discovery and summary judgment motion practice, as well as prolonged injury to reputation, upon defendants who are innocent of any wrongdoing.

CONCLUSION

Judge Trott predicted in his dissenting opinion below that "[w]hen businesses complain about the costs heaped on them by a court system with no adequate controls, I believe they will be able to point to this litigation as an example." (a-18.) The time has come for this Court to give much needed guidance on what pleading standards to apply to these cases. In recent years, the Court has provided invaluable guidance regarding the standards governing motions for summary judgment in complex commercial cases. *Celotex Corp. v. Catrett*, 477 U.S. 317 (1986); *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242 (1986); *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574 (1986). The Court should issue the writ to provide similar guidance at the pleading stage.

For the foregoing reasons, petitioners respectfully request the Court to grant certiorari to reverse the opinion of the Ninth Circuit and to reinstate the judgment of the District Court dismissing this action with prejudice.

Dated: June 6, 1994.

MELVIN R. GOLDMAN*
JACK W. LONDEN
PAUL FLUM
CAROLYN A. JOHNSTON
MORRISON & FOERSTER

Attorneys for Petitioners

* *Counsel of Record*